Statement of the Coalition for Fair and Affordable Lending (CFAL)
On
"Promoting Homeownership by Ensuring Liquidity in the Subprime Mortgage Market"
Before the
Subcommittees on Housing and Community Opportunity & Financial Institutions and Consumer Credit
Of the
Committee on Financial Services
U.S. House of Representatives

June 23, 2004

The Coalition for Fair and Affordable Lending ("CFAL") appreciates the opportunity to submit this statement concerning the importance of ensuring liquidity in the nonprime mortgage market.[1]

First, we want to commend Chairman Ney and Chairman Bachus for their continued leadership in scheduling today's hearing so Committee Members can hear suggestions from interested parties on how Congress can best preserve market liquidity while also preventing abusive lending practices and preserving access for all Americans to affordable mortgage credit.

For the reasons discussed below, we recommend that the following four features, among others, be incorporated in federal legislation embodying uniform nonprime lending standards to promote efficient capital markets and liquidity:

- ✓ **Provide lenders/purchasers with clear definitions of what is required** *(e.g., qualifying any anti-flipping loan benefit test with a "knowing or intentional" requirement and adding specific "safe harbors" indicating types of loans that are deemed to provide the required benefit*);
- ✓ **Mandate lenders/purchasers have a meaningful opportunity to correct errors** *(e.g., 90 days after closing + 90 days after discovery, with the lender in such after discovery cases being required to make full restitution <u>and</u> to pay the borrower a reasonable error penalty and reasonable attorney's fees if the error discovery is made by the borrower or a regulator)*;
- ✓ **Impose reasonable penalties that are proportional to the nature of the violation**; and

[1] The Coalition for Fair and Affordable Lending (CFAL), launched January of 2003, was formed to advocate national, uniform fair legislative standards for nonprime mortgage lending. CFAL's members make around one-third of all nonprime mortgage loans and sell into, or securitize in, the secondary market many billions of dollars in nonprime loans every month.

- ✓ **Require only limited assignee liability** *(e.g., assignees should only be held liable for violations that they know or could know based on their following reasonable industry practices for due diligence that ensure they are not purchasing loans containing statutory violations; damages for assignees should be expressly capped/limited; class actions should not be allowed; and safe harbors should be provided so that assignees can have greater certainty that no violations have occurred).*

Nonprime lending fills a vital niche in our nationwide mortgage market, with roughly 10% of the loans being made to borrowers who cannot qualify for the lowest available rate, so-called conventional or "prime" mortgages. Nonprime lending promotes homeownership for millions of families who otherwise could not qualify for a mortgage at prime rates in at least two important ways: (1) many nonprime lenders make 20%-30% or more of their loans for home purchases; and (2) they make loans to refinance homeowners' existing mortgages and allow many to utilize some of their equity to meet financial challenges or opportunities without having to sell their homes. But, the availability and affordability of these nonprime loans is highly dependent on maintaining liquidity in this market segment. Lenders must be able to sell nonprime loans they originate into the secondary market so they can obtain new capital which can then be used to make new nonprime loans, thereby increasing credit availability for borrowers who can not qualify for prime rate mortgages.

Liquidity can be seriously curtailed by overly restrictive legislation, especially if assignees of nonprime loans have broad liability for any violation made by loan originators before the assignees purchased the loans. Therefore, it is critically important that Congress address this assignee liability question with a good understanding of the issues involved and with the knowledge that legislation must limit such liability, as we note subsequently.

Uniform National Standards Are Needed

As CFAL representatives have stated in prior testimony, some lenders, brokers, and others involved in the mortgage origination process engage in inappropriate lending practices that need to be stopped.[2] Many of these abuses are fraudulent, deceptive, and already illegal.[3] However, CFAL feels that new federal statutory requirements also are needed to remove gaps or to correct weaknesses in current law. We believe that these new provisions, including new requirements for limited assignee liability, should replace the current patchwork of differing state and local "anti-predatory lending" laws and be applied on a uniform, nationwide basis to provide effective, fair and workable protections

[2] See statements on behalf of CFAL at the Subcommittees' hearings on November 5, 2003 by Steve Nadon and on March 30, 2004 by Terry Theologides.
[3] Enhanced enforcement together with more consumer financial education and counseling opportunities also are needed to help prevent them.

for all borrowers.[4] And, we want to see both federal and state regulators actively enforce these nationwide standards.

Nonprime Lending Depends On Continued Capital Liquidity

As Committee members know, housing is critically important to our nation. Not only is homeownership "the American Dream," and central to the welfare and stability of families and communities, it is vital for our nation's economy. Housing has been an essential economic engine for us. Millions of Americans rely on nonprime lenders and their home equity to help meet their credit needs and this is especially important during tighter economic times. We clearly need to ensure that they are not abused in the mortgage lending process, but we also must make certain that "protective" measures do not harm them by limiting their access to needed credit or unnecessarily increasing its cost.

Today's nonprime mortgage industry has truly become an interstate business that is increasingly dominated by large nationwide lenders. The primary reason that this business has grown dramatically in the last decade and has been able to provide credit at relatively low rates to millions of Americans who could not have qualified for conventional financing is the development of a strong secondary market for nonprime loans. Our industry has become much more automated, standardized, and efficient, and now securitizes most of the loans we originate. Roughly two-thirds of the $325 billion in nonprime mortgages originated last year were securitized. Securitization has let lenders bring in vast amounts of capital from the national and global markets. This has both enabled us to make far more credit available and to dramatically decrease the rates we charge borrowers.[5] However, overreaching, unclear or conflicting legislation, regardless of how well-intended it is, can easily disrupt the capital markets on which this industry depends for funds to make most of its loans to borrowers, and thus have a serious adverse impact on both credit availability and borrowers' credit costs.

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[4] Uniform standards are needed because the arbitrary and irrational growing patchwork of state and local laws intended to prevent mortgage lending abuses is proving to be unduly burdensome and costly. Many borrowers are not receiving adequate statutory protections. Moreover, federally chartered depositories, as well as some state chartered entities, are being exempted from these state and local laws' requirements. This creates not only an unlevel regulatory playing field for lenders, and, thus, is anti-competitive, but it also increases confusion and inconsistent levels of protection for borrowers. Many consumers are not being adequately or equally protected by these measures. These consequences of a confusing, inconsistent, and arcane patchwork of local and state laws threaten disruption to and impairment of the efficient and effective functioning of the national housing finance market.

[5] The securitization process is described in a recent GAO report, *Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending* (January 2004). See selected excerpts in the attached Appendix "A".

Assignee Liability And Poorly Crafted Statutory Requirements Limit Liquidity

Experience under various differing state and local "anti-predatory lending" laws (e.g.; Georgia; New Jersey; New Mexico) has shown that liquidity is curtailed as the capital markets react to poorly crafted and onerous requirements. Common elements in unworkable statutes include:

1. Unclear requirements which make compliance very difficult and sometimes impossible (e.g., an unqualified, undefined "tangible net benefit" requirement);
2. Limited opportunities to correct mistakes;
3. Severe penalties;
4. Class action liability; and
5. Broad assignee liability.

Not surprisingly, some states' statutes have been so poorly crafted that state legislatures---e.g.~~,~~ most recently New Jersey's---are finding it necessary to go back and amend or propose amendments to some of their laws' more unworkable provisions. CFAL believes that it is very important for Committee members to understand that such purported "fixes" have not necessarily actually fixed the liquidity problems or other problems caused by these state statutes which have forced nonprime lenders to exit these markets or substantially curtail their lending activity.

In reality, what has happened is that state law "high cost" triggers tend to operate in the market as de facto usury ceilings; accordingly, virtually no so-called "high cost" loans are being made by lenders or sold into the secondary market. When Georgia, for example, moved to change its statute, the Legislature still applied onerous provisions, including broad assignee liability, to all loans that qualified as "high cost" under their triggers. This means that there is still no liquidity for "high cost" loans in that state. The same thing is currently occurring in New Jersey. Simply put, many legitimate loans that would exceed the interest rate and/or the points and fees trigger thresholds if priced fairly on the basis of the credit risk involved now generally are not made because the assignee liability risk is too great for secondary market participants.

Rating agencies also have difficulty rating loans that are subject to such requirements, and to the extent that they can provide a rating, credit enhancements may be required to the degree that such loans are not economically viable.

Investors like clarity and are typically risk-averse, and it should surprise no one that they are unwilling or extremely reluctant to invest in loans (and charge a high risk premium) where requirements are vague and violations can prove to be extremely costly and where they have no acceptable way to limit their risks. Lenders likewise are generally unwilling to make such loans----as they can neither sell them into the secondary market, nor tolerate the high level of risk they face if the loans are retained in their own portfolio.

HOEPA Assignee Liability Requirements Also Undercut Liquidity And Limit Nonprime Credit Availability

Industry experience under the federal Home Ownership and Equity Protection Act of 1994 ("HOEPA") also demonstrates how easily market liquidity is disrupted by broad assignee liability requirements. Relatively speaking, especially when compared to many state statutes, HOEPA's requirements for loan originators are quite modest and for the most part are not difficult for lenders to meet.[6] The primary problem legitimate lenders seem to encounter with this law is when they do not realize that a loan exceeds HOEPA's "high cost" triggers, typically due to calculation error, and therefore they fail to give the required pre-closing special HOEPA disclosures. A violation subjects the loan to an expanded 3-year right of rescission without any meaningful right to cure such error. Many lenders are unwilling to take this additional legal risk. Moreover, most lenders today also will not make HOEPA loans because many people perceive that such loans are viewed as "predatory." This reputational risk causes lenders to forgo making "high cost" loans even though such loans, like other loans, would be priced on the basis of borrower risk and would meet the needs of consumers who cannot qualify for lower-priced loans. However, not only is credit availability curtailed by many originators' reaction to HOEPA's provisions, but the market is further restricted because almost no one will purchase such loans in the secondary market. This is primarily due to HOEPA's broad assignee liability provisions.

Lenders in the prime and nonprime mortgage markets normally are NOT subject to assignee liability. This longstanding general rule, however, now has been changed by HOEPA and laws in some states (e.g., Georgia; New Jersey) with regard to loans that exceed the rate and/or point and fee trigger thresholds and are deemed "high cost" mortgages. The assignee/purchaser of any such "high cost" loan is subject to liability for violations of the HOEPA statute and some state laws, and for other violations by the originator (e.g., state law fraud claims). In light of this, there is essentially no secondary market liquidity for HOEPA or other "high cost" loans.

[6] See November 5, 2003 statement of Steve Nadon at pp. 6-8.

Clear And Reasonable Uniform Standards Are Needed

In conclusion, CFAL believes that Congress should pass fair, effective, and workable uniform national standards for nonprime mortgage lending. Such standards will help preserve and expand liquidity for nonprime lending and make credit and homeownership more widely available. As explained in more detail earlier, these standards should, among other things:

- ✓ **Provide lenders/purchasers with clear definitions of what is required**;
- ✓ **Mandate lenders/purchasers have a meaningful opportunity to correct errors**;
- ✓ **Impose reasonable penalties that are proportional to the nature of the violation**; and
- ✓ **Require only limited assignee liability.**[7]

* * *

CFAL appreciates the opportunity to present this testimony, and we look forward to continuing to work with Committee members on a bipartisan basis and other interested parties to develop fair and workable uniform national standards, including limited assignee liability provisions, for nonprime mortgage lending.

Please contact Wright Andrews, CFAL's Executive Director, at 202-742-4245 if you have questions, or if we can be of assistance to you on these important issues.

[7] See Appendix "B" containing an example of a possible assignee liability provision that might be incorporated into a new law amending HOEPA.

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Appendix "A"

Excerpt from GAO Report, "*Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending,*" (January 2004) at pp. 72-74

By providing lenders with an additional source of liquidity, the secondary market can benefit borrowers by increasing the availability of credit and, in general, lowering interest rates. While a secondary market for prime mortgage loans has existed for decades, a relatively recent secondary market for subprime loans now offers these potential benefits to subprime borrowers as well. . . .

Originators of mortgage loans—which can include banks, other depository institutions, and mortgage lenders that are not depository institutions—may keep the loans or sell them in the secondary market. Secondary market purchasers may then hold the loans in their own portfolio or may pool together a group of loans and issue a mortgage-backed security that is backed by a pool of such loans. The securitization of mortgage loans became common during the 1980s and, by the 1990s, had become a major source of funding in the prime mortgage market. . . .

The securitization of subprime mortgage loans did not become common until the mid-1990s. The development of a secondary market for these loans has been an important factor in the growth of subprime lending, expanding subprime lenders' access to funds and thus increasing the availability of subprime credit. The trade journal Inside B&C Lending estimated that in 2002 approximately 63 percent of new subprime mortgages, representing $134 billion, were securitized. The originators of subprime loans are often nonbank mortgage and finance companies. As secondary market participants—such as the Wall Street investment firms that have been the major underwriters for subprime securities—have grown more willing to purchase these instruments, subprime originators have gained access to an important source of liquidity that has allowed them to make more subprime loans.

As shown in figure 4, the process of securitization starts with borrowers obtaining mortgages either directly from a lender or through a broker. The lender then creates a pool—a separate legal entity that purchases the mortgages and issues securities based on them. The lender hires a credit rating agency, which has no direct financial interest in the deal, to confirm the value of the securities based on the expected return and risks of the underlying mortgages. At the same time, the lender hires an underwriter to sell the securities to investors. The value of the securities is based exclusively on the mortgages themselves and is separate from the financial condition of the original lender. Finally, a servicer is hired to collect mortgage payments from the borrowers and disburse interest and principal payments to the investors. The process described above is for securitizations performed via private conduits—that is, without the participation of government-sponsored enterprises.

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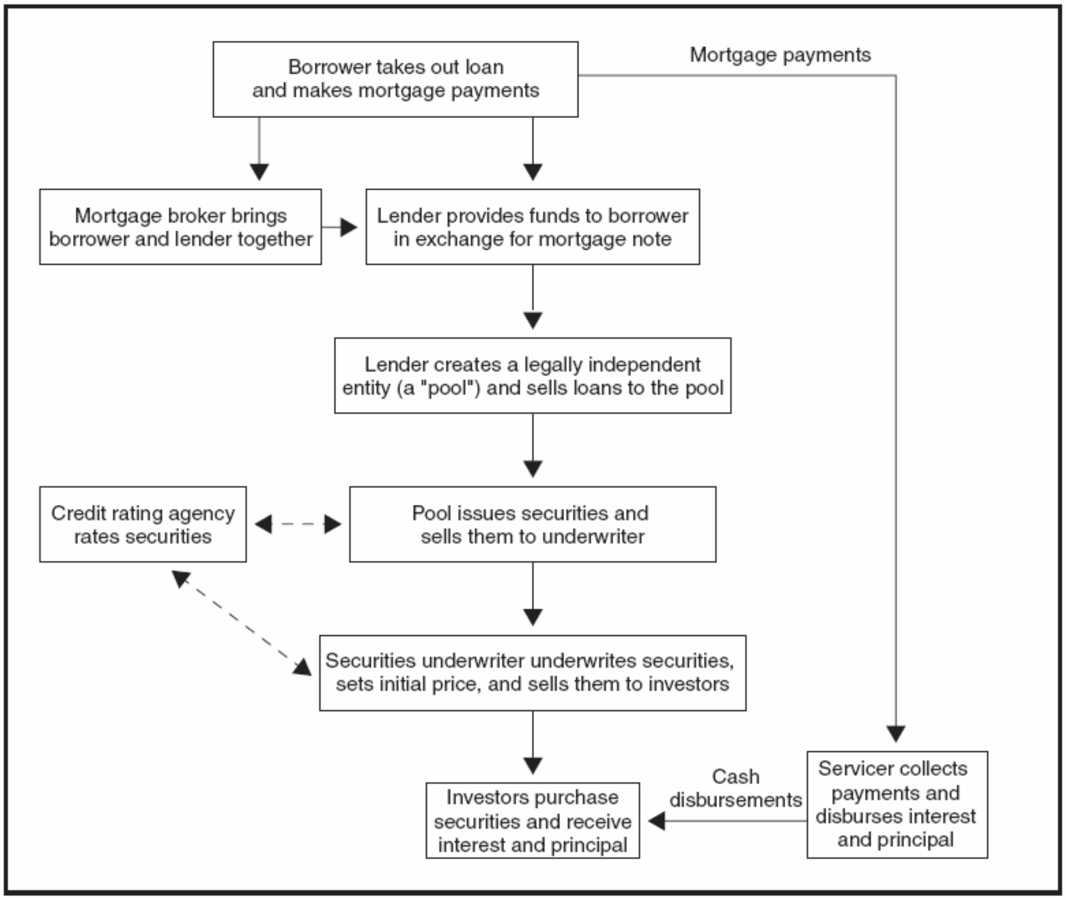
Figure 4: Steps in the Securitization of Residential Mortgages



Source: GAO.

Note: This chart represents the process for fully private securitizations and not for government-sponsored enterprises.

Appendix "B"

POSSIBLE AMENDMENTS RELATING TO LIABILITY OF ASSIGNEES-

RIGHTS UPON ASSIGNMENT OF HIGH-COST MORTGAGES- Section 131(d) of the Truth in Lending Act (15 U.S.C. 1641(d)) is amended—

(A) by re-designating paragraphs (3) and (4) as paragraphs (4) and (5), respectively; and

(B) by striking paragraphs (1) and (2) and inserting the following new paragraphs:

'(1) IN GENERAL- Any person who purchases or is otherwise assigned a high-cost mortgage shall be subject, in an individual action only, to all affirmative claims and defenses with respect to that mortgage that the consumer could assert against the creditor of the mortgage, unless the purchaser or assignee demonstrates, by a preponderance of the evidence, that a reasonable person exercising ordinary due diligence could not determine with reasonable certainty, based on information contained in the documentation required by this title, the itemization of the amount financed, and other disclosure of disbursements, that a violation of this title or other applicable law had occurred. The preceding sentence does not affect rights of a consumer under subsection (a), (b), or (c) of this section or any other provision of this title. For purposes of this section, it shall be presumed that a purchaser or assignee has exercised such due diligence if the purchaser or assignee demonstrates by a preponderance of the evidence that it: (1) has in place, at the time of the purchase or assignment of the loan, policies that expressly prohibit its purchase or acceptance of assignment of any high-cost mortgage containing such violations; (2) requires by contract that a seller or assignor of home loans to the purchaser or assignee represents and warrants to the purchaser or assignee that either (a) it will not sell or assign any high-cost mortgage to the purchaser or assignee that contain such violations or (b) that the seller or assignor is a beneficiary of a representation and warranty from a previous seller or assignor to that effect; and (3) exercises reasonable due diligence, based on a reasonable sample of loans at or before the time of purchase or assignment of home loans or within a reasonable period of time thereafter, to prevent the purchaser or assignee from purchasing or taking assignment of any high-cost mortgage containing such violations.

‘(2) Notwithstanding any other provision of law, relief provided as a result of any action made permissible by paragraph (1) may not exceed the greater of–
‘(A) with respect to actions based upon a violation of this title, the amount specified in section 130; or
‘(B) with respect to other actions, the sum of (i) the amount of all remaining indebtedness; and (ii) the total amount paid by the consumer in connection with the transaction; and
‘(C) provided, however, in the case of either (2)(A) or (2)(B), in determining the amount of the award, the court shall consider, among other relevant factors, the amount of any actual damages awarded and the extent to which the damages are non-compensatory and designed to punish or deter future conduct of the purchaser or assignee, the lack of such purchaser’s or assignee’s knowledge of or participation in the facts or circumstances giving rise to the violations and claim and defenses, the materiality of the violation, the steps taken to cure the violation, the relative harm to the consumer, and the financial resources of the purchaser or assignee.

‘(3) CLARIFICATION OF TERMS- For purposes of determining the liability of assignees under this Section, the terms `purchaser' and `assignee' shall not include—
‘(A) persons whose interest in high-cost mortgages is limited to a security interest or who acquire title as a result of the foreclosure of such security interest;
‘(B) broker dealers that trade in mortgage loans and related mortgage securities and otherwise are not involved in any material respect in the terms and conditions under which such mortgage loans were made or such securities were issued; or
‘(C) passive investors in securities or interests in securities based on and backed by a pool of residential mortgage loans.’.